I. INTRODUCTION

PURPOSE OF CAPITAL

Bank capital performs several very important functions. It absorbs losses, promotes public confidence, restricts excessive asset growth, and provides protection to depositors and the FDIC insurance funds.

Absorbs Losses - Capital allows institutions to continue operating as going concerns during periods when operating losses or other adverse financial results are being experienced.

Promotes Public Confidence - Capital provides a measure of assurance to the public that an institution will continue to provide financial services even when losses have been incurred, thereby helping to maintain confidence in the banking system and minimize liquidity concerns.

Restricts Excessive Asset Growth - Capital supports prudent growth and restrains unjustified expansion of assets by requiring that asset growth be funded by a commensurate amount of additional capital.

Provides Protection to Depositors and the FDIC Insurance Funds - Placing owners at significant risk of loss should the institution fail helps to minimize the potential "moral hazard" and promotes safe and sound banking practices.

As the insuring agency whose primary purpose is the protection of depositors, the FDIC has a direct and obvious financial stake in the last-mentioned function. Consequently, the FDIC has traditionally placed a great deal of attention in its examination and supervisory programs on institutions' capital positions. For example, the appraisal of assets provides a determination of adjusted as opposed to book capital. Similarly, substandard assets, or those listed for Special Mention or as Concentrations, are identified because these may have the potential of resulting in losses and a weakened capital position at some future point. Moreover, review of the policies and practices of management can disclose weaknesses that may bring about losses and dissipation of capital. An institution's earnings performance and dividend policies are analyzed for their impact on the institution's present and expected level of capitalization. Also, serious contingent liabilities that may arise in conjunction with trust department activities, litigation in which the institution is the defendant, or contingencies that emanate from other sources are carefully scrutinized since they may lead to depletion of capital.

TYPES OF CAPITAL-BASED RULES

The FDIC has issued several capital-based regulations affecting either insured state nonmember banks or all insured institutions. These regulations establish minimum capital standards, a framework for taking supervisory actions for institutions which are not adequately capitalized, a risk-related deposit insurance premium system based in part on capital levels, and restrictions prohibiting certain bank related activities.

These capital-based regulations include the following:

Minimum Leverage Capital Standard - Part 325 of the FDIC Rules and Regulations establishes the criteria and standards FDIC will use in calculating the minimum leverage capital requirement and in determining capital adequacy. A more thorough discussion of these standards is included in paragraph V. of this section.

Minimum Risk-Based Capital Standard - The Part 325 - Appendix A Statement of Policy on Risk-based Capital establishes a risk adjusted capital framework which, together with the leverage capital standard, is used in the examination and supervisory process. The risk-based framework includes a definition of capital for risk-based capital purposes, a system for calculating risk-weighted assets by assigning assets and off-balance sheet items to broad risk categories, and a minimum supervisory ratio of capital to risk-weighted assets. A more thorough discussion of this standard is included in paragraph V. of this section.

Statement of Policy on Capital Adequacy - Part 325 - Appendix B provides some interpretational and definitional guidance as to how Part 325 will be administered and enforced. A more thorough discussion of this policy statement is included in paragraph VI. of this section.

Prompt Corrective Action - Part 325 of the FDIC Rules and Regulations implements section 38 of the FDI Act by establishing a framework for taking prompt supervisory actions against insured state nonmember banks that are not adequately capitalized. Refer to the Formal Administrative Actions Section of this manual *for a more thorough discussion. Certain provisions of the FDIC's prompt corrective action rules apply to all insured depository institutions that are critically undercapitalized.*

Other Areas - Capital-based standards are used in the following regulations to restrict or prohibit an institution's activities.

Risk-Related Insurance Premiums	*Part 327 of the FDIC Rules & Regulations*
Brokered Deposits	*Part 337.6 of the FDIC Rules and Regulations*
Limits on Extensions of Credit to Insiders	*Part 337.3 of the FDIC Rules and Regulations & FRB Regulation O*
Securities Activities	*Part 337.4 of the FDIC Rules and Regulations*
Activities and Investments of Insured State Nonmember Banks	*Part 362 of the FDIC Rules &Regulations*
Limitations on Interbank Liabilities	*Part 206 of FRB Regulations*
Limitations on Federal Reserve Discount Window Advances	*Section 10B of Federal Reserve Act*
Grounds for Appointing Conservator or Receiver	*Section 11(c)(5) of the FDI Act*

II. CAPITAL ADEQUACY VS. CAPITAL RULES

It is important to note that what is adequate capital for safety and soundness purposes may differ significantly from minimum leverage and risk-based standards and the "Well Capitalized" and "Adequately Capitalized" definitions that are used in the Prompt Corrective Action regulations and certain other capital-based rules. The minimums set forth in the leverage and risk-based capital standards apply to sound, well-run banks. Most banks do, and generally are expected to, maintain capital levels above the minimums, based on the institution's particular risk profile. In all cases, banks should maintain capital commensurate with the level and nature of risks, including the volume and severity of adversely classified assets, to which they are exposed.

III. COMPONENTS OF CAPITAL

LEVERAGE CAPITAL

Banks must maintain at least the minimum leverage requirement set forth in Part 325. The minimum leverage requirement consists only of Tier 1 (Core) Capital.

Tier 1 Capital or Core Capital is defined in Part 325 and means the sum of:

- *common stockholders' equity;*
- *noncumulative perpetual preferred stock;*
- *minority interests in consolidated subsidiaries;*

minus

- *all intangible assets (other than limited amounts of mortgage servicing rights and purchased credit card relationships and certain grandfathered supervisory goodwill;*
- *identified losses (to the extent that Tier 1 capital would have been reduced if the appropriate accounting entries to reflect the identified losses had been recorded on the institution's books);*
- *investments in securities subsidiaries subject to section 337.4; and*
- *unrealized holding gains or (losses) on available-for-sale securities.*

RISK-BASED CAPITAL

While the leverage capital standard serves as a useful tool for assessing capital adequacy, there is a need for a capital measure that is more explicitly and systematically sensitive to the risk profiles of individual banks. As a result, the Statement of Policy on Risk-Based Capital (Appendix A to Part 325) was adopted to supplement the existing Part 325 leverage capital regulation. It does not eliminate the leverage capital standard. Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital elements" (Tier 1) and *"supplementary capital elements" (Tier 2). To qualify as an element of Tier 1 or Tier 2 capital, a capital instrument should not contain or be subject to any conditions, covenants, terms, restrictions, or provisions that are inconsistent with safe and sound banking practices.*

Tier 1 Capital for Risk-Based Capital standards is the same as under the Leverage Capital standard.

Tier 2 Capital consists of:

- *allowances for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets;*
- *cumulative perpetual preferred stock, long-termed preferred stock (original maturity of at least 20 years) and any related surplus;*
- *perpetual preferred stock (where the dividend is reset periodically);*
- *hybrid capital instruments, including mandatory convertible debt; and*
- *term subordinated debt and intermediate-term preferred stock.*

The aggregate amount of term subordinated debt and intermediate-term preferred stock is limited to 50 percent of Tier 1 capital. It should have an original average maturity of at least 5 years to qualify and should not be redeemable at the option of the holder prior to maturity, except with the prior approval of the FDIC. Allowable Tier 2 capital in total cannot exceed Tier 1 capital.

Total Risk-Based Capital is calculated by deducting from the sum of Tier 1 capital plus Tier 2 capital: investments in unconsolidated banking and finance subsidiaries and reciprocal holdings of capital instruments of other banks.

IV. CAPITAL ACCOUNT ADJUSTMENTS

Deductions From Tier 1 Capital For Identified Losses And Inadequate ALLL

Part 325 provides that, on a case-by-case basis and in conjunction with supervisory examinations, other deductions from capital may be required, including any adjustments deemed appropriate for assets classified Loss. Further, the definition of Tier 1 capital under the Part 325 leverage capital standard specifically provides for the deduction of identified losses (which may include items classified loss and any provision expenses that are necessary to replenish the ALLL to an adequate level).

When it is deemed appropriate during an examination to adjust capital for items classified Loss or for an inadequate ALLL, the following method should be used by examiners. This method avoids certain adjustments that may otherwise result in a "double deduction" (e.g., for loans classified loss), particularly when Tier 1 Capital already has been effectively reduced through the provision expenses that were recorded in establishing an adequate ALLL. Additionally, this method addresses those situations where an institution has overstated the amount of its Tier 1 capital by failing to take the provision expenses that are necessary to establish and maintain an adequate ALLL.

Method

- *Deduct the amount of loss for items other than loans and leases in the calculation of Tier 1 capital. If ORE general reserves exist, see the following discussion of "Capital Treatment of ORE Reserves."*

- *Deduct the amount of loss for loans and leases from the ALLL in the calculation of Tier 2 capital.*

The evaluation of the adequacy of the ALLL includes the consideration of the amount of adversely classified loans and leases. If the ALLL is considered inadequate, an estimate of the amount of provision needed for an adequate ALLL should be made. The estimate is after the identified losses have been deducted from the ALLL. Loans and leases classified Doubtful should not be directly deducted from capital. Rather, they should be included in the evaluation of the ALLL and, if appropriate, will be accounted for by the adjustment for an inadequate ALLL.

An adjustment from Tier 1 capital to Tier 2 capital for an inadequate ALLL should be made only when the amount is considered significant. The decision as to what is significant is a matter of judgement. As such, consideration should be given to how much the adjustment would change the Leverage Capital ratio, how much the reader's perception of the institution's capital level will be influenced, or whether the institution's capital category for purposes of Prompt Corrective Action, risk-related insurance premiums, and other pertinent capital-based rules will be changed.

Capital Treatment Of Other Real Estate (ORE) Reserves

ORE reserves, whether considered general reserves or specific reserves, are not recognized as a component of capital for either Risk-Based Capital or Leverage Capital standards.

The amount of ORE Loss classifications that are subtracted from capital when calculating Tier 1 capital should consider the existence of any general ORE reserves. The actual deduction from Tier 1 capital for "Assets Other Than Loans & Leases Classified Loss" should take into account any reserves established as general ORE reserves. To the extent these reserves adequately cover the risks inherent in the ORE portfolio as a whole, including any individual ORE properties that are classified Loss, the amount of such Loss should not be deducted in determining Tier 1 capital.

Liabilities Not Shown on Books

Non-book liabilities have a direct bearing on the adjusted capital computation. These definite and direct but unbooked liabilities (contingent liabilities are treated differently) should be carefully verified and supported by factual comments. Examiners are to recommend to management that bank records be adjusted so that all liabilities are properly reflected. Deficiencies in a bank's accrual accounting system which are of such magnitude that the institution's capital accounts are significantly overstated constitutes an example of non-book liabilities for which adjustment should be made in the examination capital analysis. Similarly, adjustment to capital should be made for material deferred tax liabilities or unpaid bills significant in amount which are not reflected on the books.

V. MINIMUM CAPITAL STANDARDS

Institutions are expected, at a minimum, to maintain capital levels that meet both the leverage capital requirement and the risk-based capital standard.

Part 325 sets forth minimum acceptable capital requirements for fundamentally sound, well-managed institutions having no material or significant weaknesses. Thus, the FDIC is not precluded from requiring an institution to maintain a higher capital level based on the institution's particular risk profile. Where the FDIC determines that the financial history or condition, managerial resources and/or the future earnings prospects of an institution are not adequate, or where an institution has sizeable off-balance sheet or funding risks, excessive interest rate risk exposure, or a significant volume of assets adversely classified, the FDIC may determine that the minimum amount of capital for that institution is greater than the minimum standards stated below.

Minimum leverage capital requirement:

- *Not less than 3 percent Tier 1 capital to Total Assets if CAMEL 1 rating and not anticipating or experiencing any significant growth.*
- *All others should have a minimum of 100 to 200 basis points higher and thus a minimum leverage capital standard of not less than 4 percent.*
- *Thus, banks normally are in violation of the Part 325 regulation if they have a Tier 1 leverage capital ratio of less than 4 percent*

Minimum risk-based capital standard:

The risk-based standard uses a broad-brushed approach which focuses primarily on broad categories of credit risk. The procedures for computing risk-weighted assets, which are detailed in Appendix A to Part 325, are based primarily on the nature of the obligor (government vs. bank vs. private sector obligors), but some qualifying guarantees and collateral are considered. The procedures also make use of conversion factors, which are applied to off-balance sheet items for determining a "credit equivalent amount" before assigning the off-balance sheet items to an appropriate risk weight category.

- *The minimum standard is that total capital must be equal to at least 8 percent of risk-weighted assets, with at least one-half of this minimum requirement (or 4 percentage points) comprised of Tier 1 capital.*
- *An important consideration is that the risk-based framework cannot be used as a sole determinant of a bank's capital adequacy for safety and soundness purposes. It does not take explicit account of many other factors that can affect a bank's financial condition such as:*
  - *Overall interest rate risk exposure;*
  - *Liquidity, funding and market risks;*

- *The quality and level of earnings;*
- *Investment or loan portfolio concentrations;*
- *The quality of loans or investments (including the level and severity of problem and classified assets and the adequacy of the allowance for loan and lease losses);*
- *The effectiveness of loan and investment policies; and*
- *Management's overall ability to monitor and control financial and operating risks, including the risk presented by concentrations of credit and nontraditional activities.*

The risk-based capital ratio is but one element in the assessment of overall capital adequacy or the final supervisory judgement on a bank's capital adequacy. This judgement may differ significantly from conclusions drawn solely from the absolute level of the bank's risk-based capital ratios. In light of these considerations, banks generally will be expected to operate at capital levels above the minimum capital standards. Banks contemplating significant expansion plans, as well as those institutions with high or inordinate levels of risk, should hold capital commensurate with the level and nature of the risks to which they are exposed.

VI. FDIC STATEMENT OF POLICY ON CAPITAL ADEQUACY

The statement of policy on capital adequacy, which is Appendix B to Part 325, provides some interpretational and definitional guidance as to how the regulation will be administered and enforced by the FDIC. The policy does not address the prompt corrective action provisions of section 38 of the Federal Deposit Insurance Act and Subpart B of Part 325, which generally apply to institutions with inadequate levels of capital.

Banks failing to meet the minimum leverage and/or risk-based capital ratios normally can expect to have any application submitted to the FDIC denied (if such application requires the FDIC to evaluate the adequacy of the institution's capital structure) and also can expect to be subject to the use of capital directives or other formal enforcement action by the FDIC to increase capital.

Banks Which are Fundamentally Sound and Well-Managed

Section 325.3(a) of the regulation specifies that the capital standards set forth therein are the minimum acceptable for banks whose overall financial condition is fundamentally sound, which are well-managed and which have no material or significant financial weaknesses. While the FDIC will make this determination in each case based on the bank's own condition and specific circumstances, the definition generally applies to those banks evidencing a level of risk which is no greater than that normally associated with a Composite rating of 1 or 2 under the Uniform Financial Institutions Rating System. Banks meeting this definition which are in compliance with the minimum capital requirements will not generally be required by the FDIC to raise new capital from external sources. The FDIC does, however, encourage such banks to maintain capital above the minimums and examiners should carefully evaluate the bank's earnings and growth trends, dividend policies, capital planning procedures and other factors important to the continuous maintenance of adequate capital. Adverse trends or deficiencies in these areas should be subject to criticism at regular examinations and may be an important factor in the FDIC's action on applications submitted by such banks. In addition, the FDIC's consideration of capital adequacy in banks making applications to the FDIC will also fully examine the expected impact of those applications on the bank's ability to maintain its capital adequacy.

Other Banks

Banks not meeting the definition set forth above, that is, banks evidencing a level of risk which is at least as great as that normally associated with a Composite rating of 3, 4 or 5 under the Uniform Financial Institutions Rating System, will be required to maintain capital higher than the minimum regulatory requirement and at a level deemed appropriate in relation to the degree of risk within the institution. These higher capital levels should normally be addressed through Memoranda of Understanding between the FDIC and the bank or, in cases of more pronounced risk, through the use of formal enforcement actions under Section 8 of the Federal Deposit Insurance Act.

Capital Requirements of Primary Regulator

Notwithstanding the above, all banks will be expected to meet any capital requirements established by their primary State or Federal regulator which exceed the minimum capital requirement set forth in the regulation. In addition, the FDIC will, when establishing capital requirements higher than the minimum set forth in the regulation, consult with the bank's primary State or Federal regulator.

Capital Plans

Section 325.4(b) specifies that any bank which has less than its minimum leverage capital requirement is deemed to be engaging in an unsafe and unsound banking practice unless it has submitted, and is in compliance with, a plan approved by the FDIC to increase its Tier 1 leverage capital ratio to such level as the FDIC deems appropriate. Under the prompt corrective action regulations, a bank must file a written capital restoration plan within 45 days of the date that the bank receives notice or is deemed to have notice that the bank is undercapitalized, significantly undercapitalized or critically undercapitalized, unless the FDIC notifies the bank in writing that the plan is to be filed within a different period.

Written Agreements

Section 325.4(c) provides that any insured depository institution with a Tier 1 capital to total assets (leverage) ratio of less than 2 percent must enter into and be in compliance with a written agreement with the FDIC (or with its primary federal regulator with FDIC as a party to the agreement) to increase its Tier 1 leverage capital ratio to such level as the FDIC deems appropriate or may be subject to a section 8(a) termination of insurance action by the FDIC. Except in the very rarest of circumstances, the FDIC will require that such agreements contemplate immediate efforts by the depository institution to acquire the required capital. The guidance in this section is not intended to preclude the FDIC from taking section 8(a) or other enforcement action against any institution, regardless of its capital level, if the specific circumstances deem such action to be appropriate.

VII. EVALUATION OF A BANK'S CAPITAL ADEQUACY

Banks are expected to meet any capital requirements properly established by its primary State or Federal regulator which exceed the minimum capital requirement set forth in the regulation. Therefore, the process of determining the adequacy of a bank's capital on an ongoing basis includes a qualitative evaluation of the critical variables that directly bear on the institution's overall financial condition.

By requiring that the FDIC consider the adequacy of capital in connection with applications for deposit insurance (and in other matters), the law gives explicit statutory recognition to the importance this factor assumes in the safe and sound operation of the nation's banking system. Banks are too dissimilar in asset quality and distribution, management competency, liability composition, local operating environment, and in many other respects, to permit use of standards based on one or a few criteria only. Therefore, if any generalization on the subject may be made at all, it is that capital of any given bank should be sufficient to support the volume, type and character of the business presently conducted, provide for the possibilities of loss inherent therein, and permit the bank to continue to meet the reasonable credit requirements of the area served.

Qualitative Considerations

The process of determining the adequacy of a bank's capital begins with a qualitative evaluation of critical variables that directly bear on the institution's overall financial condition. These are discussed immediately below.

Assets - The quality, type, liquidity and diversification of assets (including off balance sheet activity), with particular reference to assets adversely classified and the adequacy of the ALLL, are necessarily vital factors in determining the adequacy of capital.

Earnings - A bank's current and historical earnings record is one of the key elements to consider when assessing capital adequacy. Good earnings performance enables a bank to fund its growth and remain competitive in the marketplace while at the same time retaining sufficient equity to maintain a strong capital position. The institution's dividend policy is also of importance. Excessive dividends can negate even exceptional earnings performance and result in a weakened capital position, while a too low dividend return lowers the attractiveness of the stock to investors, which in turn can be a detriment should the bank need to sell additional equity. Generally, earnings should first be applied to the elimination of losses and the establishment of necessary reserves and prudent capital levels, and that dividends be disbursed in reasonable amounts after full

consideration of those needs. Refer to the Bank Earnings Section for an additional discussion on the subject.

Liquidity and Funds Management - Other things being equal, the lower a bank's level of liquidity or the higher its overall level of interest rate risk exposure, the greater its capital requirements may need to be. Institutions which are in a constricted liquidity situation may have no alternative but to dispose of assets at a loss in order to honor funds outflows, and such losses must be absorbed by the capital accounts. The liquidity posture of the institution can, therefore, impact the level of capital support desired. Similarly, institutions with excessive interest rate risk exposure may experience a significant decline in capital levels as a result of unfavorable changes in interest rates.

Deposit Structure - Capital adequacy must also be analyzed in light of the historical and projected rate of growth of the bank's deposit accounts. If a bank is located in a strongly developing market and earnings retention is unable to keep pace with deposit growth, it is clear that management must recognize its responsibility to take all reasonable steps to augment the capital accounts through whatever means possible. In addition to growth trends, the presence of volatile deposit accounts or concentrations in the deposit structure are also relevant. The greater the instability of the deposit base, the greater the level of capital support desired.

Contingent Liabilities - The volume and nature of business transacted in a fiduciary capacity can be significant in the assessment of capital needs. Contingencies in this area and the possibility of surcharges must be carefully appraised. Similarly, lawsuits involving the bank as defendant or any other contingent liability, may indicate a need for a greater level of capital protection.

Local Characteristics - The general type of clientele and the stability and diversification of local business, industry or agriculture are also important considerations. Potential changes in this operating environment and the pressures of bank and non-bank competition in the delivery of financial services must also be reviewed.

Parent Company Relationship - If a bank which is a subsidiary of a holding company is in need of additional capital, a relatively common approach to solving the problem involves the parent organization borrowing funds to purchase newly issued stock of the subsidiary bank. This process is referred to as "double leverage". If the examiner were to look only at the financial statements of the bank, the results of this transaction would appear altogether beneficial, because one would see only increased equity. From the holding company perspective, however, the additional capitalization was effected by incurring debt, and the principal means of servicing that debt consists of the cash dividends to be paid by the subsidiary bank. Thus, inappropriate conclusions might be drawn if the analysis focuses exclusively on the subsidiary unit. In particular, what must be ascertained is whether the bank has the ability to sustain an adequate level of capital given the cash dividend demands of the parent holding company. A more complete discussion of holding company relationships may be found in the Related Organizations Section of this Manual.

Quality of Management - The ability, experience, depth, integrity and record of management is of utmost importance in the assessment of a bank's capital adequacy. In fact, it is difficult to conceive of a capital structure which would be capable of withstanding the deterioration that eventually results from inept or dishonest management. Sound management includes the formulation and implementation of good policies and procedures relative to loans, investments, interest rate risk management, operations, internal controls and audits and other functional areas. Deficiencies in these policies, or in how they are carried out, can readily have an adverse impact on the institution's capital position.

Quantitative Considerations

In addition to the above qualitative factors, there are numerous quantitative measurements that may be made which can give an indication of capital adequacy. The leverage and risk-based capital ratios are the most common. However, ratios are only a starting point in assessing capital adequacy and a bank's ability to withstand adversity. A high ratio, by itself, is not conclusive evidence of an institution's invulnerability, nor is a low ratio necessarily predictive of imminent failure. The prudent use of ratio analysis involves consideration of the level and trend of individual ratios and the interrelationships among related ratios. Not all factors relevant to capital adequacy determinations can be measured objectively (quality of management is the paramount example), and even those that can be measured still need to be interpreted subjectively, that is, in light of those qualitative elements of assets, earnings, liquidity, etc. These same qualifications must be made with reference to peer group comparisons (i.e., the process of contrasting an individual bank's performance with banks of similar size, type and operating environment, and the ranking of that performance on a percentile basis). Such comparisons can be useful but interpretations of such data must be made cautiously. A high or low percentile ranking is nothing more than a statement of statistical fact; one cannot conclude that a bank is performing strongly or poorly without further investigation.

Although the examiner must be ever mindful of the caveats just discussed, ratio analysis can be very informative and, indeed, must be utilized in making an informed evaluation of the adequacy of a bank's capital. In addition to the leverage and risk-based capital ratios that have already been discussed, some of the more important capital ratios are listed here. Most of these may be obtained from the Uniform Bank Performance Report (UBPR).

Equity Capital to Total Assets - Equity capital generally consists of perpetual preferred stock and common stockholders' equity, including any related surplus and undivided profits, and without any deductions for intangible assets. This is a widely used statistical indicator of capital adequacy. With this ratio as with most others, the focus of interest is on the level and trend of the relationship and on how the institution generally compares with its peers.

Equity Growth to Asset Growth - This can be a very useful indicator of developing capital problems. It compares the rate of growth of the bank's resources with the rate of growth of capital. When the number is less than one, it signifies that assets are expanding relatively faster than capital, hence a declining equity position and increasing financial leverage.

Dividends as a Percent of Income - Several variations of this ratio are set forth in the UBPR, relating cash dividends to net operating income and net income. All reflect management's decisions as to the proportion of earnings to be paid to shareholders versus the amount to be added to retained earnings. Overly liberal dividend payouts can deplete capital.

Indices of Capital Adequacy in the Bank Holding Company Environment - The importance of analyzing capital adequacy from the point of view of the entire business entity has been discussed. In addition to the consolidated leverage and risk-based capital ratios applied to bank holding companies, several of the more useful ratios for this analysis are: (1) Equity investment in subsidiaries as a percentage of holding company net worth; and (2) Equity investment in subsidiaries, less parent net worth, as a percentage of fully consolidated net operating income, less cash dividends. Both of these are measurements of double leverage, which occurs when borrowings by the holding company are used to finance the holding company's equity investments in its subsidiaries. When the first ratio exceeds 100% (or 1), it indicates that double leverage is being utilized. The second relationship provides guidance as to the number of years necessary for double leverage to be "paid back". (3) Parent liabilities as a percentage of net worth - An indicator of the extent of leverage being employed; and (4) Parent term debt as a percentage of total capitalization (the latter of which includes term debt). As has already been noted, holding companies frequently issue term debt to finance the purchase of the stock of their bank subsidiaries, as a means of enhancing the equity positions of those banks. This ratio is intended to reflect the capacity of the holding company to incur such indebtedness. The holding company data are not available in the UBPR but must be obtained form other sources. Refer to the Related Organizations Section of this Manual for further comment.

Future Performance

The current level of the quantitative and qualitative variables just discussed is important, but examiners must also consider reasonable expectations of what may occur in the future. It is not enough that capital is adequate as of the examination date. Conditions on which that judgment is based can change materially over the following few months or years. Examiners must form an opinion of what they expect the strength of the bank's capital position might be at least over the next year and perhaps several years. In order to form this opinion examiners should

review the bank's plan and the underlying assumptions. Such a review is largely a reasonableness check to see if forecasted numbers and the underlying assumptions are consistent with what the examiner has observed regarding the trend of historical performance, the volume of nonaccrual and renegotiated debt and other non-earning or marginal earning assets, loan demand, deposit growth, competition, general composition and strength of the local economy, expansion plans, plans to exercise new powers and similar factors. Finally the plan must be reasonable in relation to the abilities and depth of bank management. For instance, a plan to increase income through a securities trading account, or to reduce rate sensitivity through use of the future markets, may be viewed skeptically if bank management has no expertise in these areas. Even more conventional plans may not be achieved if management is weak and therefore assurance of sound future performance is reduced.

There will be occasions when examiners should make their own projections. This would be appropriate in instances where there is significant uncertainty whether the bank's future performance will be satisfactory and the bank has no plan or the bank's forecast is unreasonable or highly dependent on the outcome of uncertain variables such as a particular movement in interest rates.

Discussion with management is an essential part of the forecasting or plan reviewing process, and examiners should freely discuss their concerns and their forecasts. Examiners should include in their comments, and consider in their evaluation, any information on future prospects which may have a material adverse effect on either the volume of capital, or the variables upon which capital adequacy is judged. If adverse future performance is a concern, especially if that concern is sufficient to impact the examiner's rating, comments in the examination report should include pro forma capital ratios or other numerical estimates used by the examiners. Comments should briefly describe how the forecast was made and management's reaction to it if there is disagreement.

It is emphasized that examiner disagreements with and adjustments to the bank's plan, or the examiner's own forecast, are for use by the examiner in forming capital adequacy judgments and highlighting potential problem areas to pursue with management. Care should be taken in discussions and written comments not to present the examiner's forecast or opinion as a certainty, nor to recommend specific transactions or strategies to management based on an examiner's forecast.

VIII. RATING THE CAPITAL FACTOR

Adequacy of the capital base is one of the elements which must be evaluated to arrive at a composite rating of the bank, in accordance with the Uniform Financial Institutions Rating System. This determination is a judgmental process and necessitates that the examiner take into account all of the subjective and objective variables, concepts and guidelines that have been discussed above. The rating scheme itself is based on a scale of "1" through "5". Banks with capital ratings of "1" or "2" are considered to presently have adequate capital and are expected to continue to maintain adequate capital in future periods. Although both have adequate capital, "1" rated banks will generally have capital ratios that exceed ratios in "2" rated banks and/or their qualitative and quantitative factors will be such that a lower level of capital is acceptable. A "3" rating should be assigned when the relationship of the capital structure to the various qualitative and quantitative factors comprising the analysis is adverse, or is expected to become adverse in the relatively near future (12 to 24 months) even after giving weight to management as a mitigating factor. Banks rated "4" or "5" are clearly inadequately capitalized, the latter representing a situation of such gravity as to threaten viability and solvency.

IX. INCREASING CAPITAL IN OPERATING BANKS

There are three basic alternatives available for increasing the level of capital in operating banks: 1) Increased earnings retention through higher earnings and/or lower cash dividend rates. Earnings may be improved, for example, by tighter controls over certain expense outlays, repricing of loans, fees, or service charges, upgrading of credit standards and administration so to reduce loan or securities losses, or through various other adjustments. 2) Sale of additional capital stock. **3) Direct contribution by owners to capital accounts. The sale or merger of the institution may also be a consideration, particularly where such action is consistent with** the prompt corrective action provisions in section 38 of the FDI Act.

Often a capital enhancement program will focus initially on earnings conservation and elimination of excessive risks. Sometimes this proves to be insufficient, however, and the sale of new equity must be pursued. In such cases and to inform the Regional Director as to the practical possibilities of new stock sales, the examiner should indicate in the Supervisory Section of the examination report the sources from which such funds might be obtained. This information will also be helpful as background data for preliminary discussions with the State banking supervisor on corrective programs to be developed. It is suggested the following information could be incorporated into the report, at the examiner's discretion: 1) A complete list of present shareholders, indicating amounts of stock held and their financial worth, insofar as available. Small holdings may be aggregated if a complete listing is impractical. 2) Information concerning individual directors relative to their capacity and willingness to purchase stock. 3) A list of prominent customers and depositors of the bank who are not shareholders but who might possibly be interested in acquiring stock. 4) A list of other individuals or possible sources of support in the community who, because of known wealth or for other reasons, might desire to subscribe to new stock.

Any other data bearing upon the issue of raising new capital along with the examiner's opinions regarding the most likely prospects for the sale of new equity should be included in the examination report. Obviously, the more severe the capital deficiency, the more detailed these background facts and circumstances need to be.

The FDIC's authority to enforce capital standards in operating banks includes the use of written agreements and capital directives, as well as discretionary action in connection with Section 18 matters (capital retirements, capital adjustments, branch bank applications, and changes in location) and recourse to the enforcement provisions of Section 8(a) and 8(b) of the FDI Act and the prompt corrective action provisions in section 38 of the FDI Act and FDIC's Part 325 Regulation. A complete discussion on the use of these powers is included in the Formal Administrative Actions Section. Specific recommendations on capital adequacy should not be made solely on the examiner's initiative; coordination between the examiner and Regional Director is essential in this often sensitive area. If the level or trend of the bank's capital position is adverse, the matter should certainly be discussed with management and commented on in the open section of the examination report. It is particularly important that the institution's plans to correct the capital deficiency be accurately determined and noted in the report, along with the examiner's assessment of the feasibility and sufficiency of those plans.

In some instances, bank management will respond to supervisory authorities' concern over the level of the bank's capitalization by attempting to reduce the institution's total resources. Sometimes this intentional shrinkage of assets will be accomplished by disposing of short-term, marketable assets and allowing volatile liabilities to run off. This reduction obviously does result in a relatively higher capital-to-assets ratio, but it may also leave the bank in a much more strained liquidity posture. It is, therefore, a strategy that can have adverse consequences from a safety and soundness perspective, and examiners should be alert to the possibility in banks which are experiencing capital adequacy problems.

Disallowing the Use of Bankruptcy to Evade Commitment to Maintain the Capital of a Federally Insured Depository Institution

Section 2522(c) of the Crime Control Act of 1990 amended the Bankruptcy Code to require that in Chapter 11 bankruptcy cases the trustee shall seek to immediately cure any deficit under any commitment by a debtor to maintain the capital of an insured depository institution. Chapter 11 cases are those in which a debtor company seeks to reorganize its debt. In addition, section 2522(d) provides an eighth priority in distribution for such commitments. These provisions place the FDIC in a strong, preferred position with respect to a debtor if a commitment to maintain capital is present and the institution is inadequately capitalized.

This provision will only be useful to the FDIC if commitments to maintain capital can be obtained from owners of institutions such as holding companies, or other corporations or financial conglomerates. Examples of situations where opportunities might exist include situations where a prospective owner might be attempting to

mitigate a factor such as potential future risk to the insurance funds or when the FDIC is providing assistance to an acquirer. Also, in accordance with the prompt corrective action provisions in Part 325, undercapitalized state nonmember banks are required to file a capital plan with the FDIC and, before such a capital plan can be accepted, any company having control over the institution would need to guarantee the bank's compliance with the plan. However, in any case, a commitment to maintain capital should be considered only as an additional enhancement and not as a substitute for actual capital.